

# Tech Q&A

What needs to be considered in the classification of a joint arrangement as a joint venture or a joint operation under HKFRS 11 *Joint Arrangements*?

**T**he classification of joint arrangements requires the parties to assess their rights and obligations arising from the arrangement. When making that assessment, the following shall be considered:

- (a) The structure of the joint arrangement; and
- (b) When the joint arrangement is structured through a separate vehicle:
  - i. The legal form of the separate vehicle;
  - ii. The terms of the contractual arrangement; and
  - iii. When relevant, other facts and circumstances.

## **The structure of the joint arrangement**

A joint arrangement that is not structured through a separate vehicle is a joint operation. A separate vehicle is defined in the standard as a separately identifiable financial structure, including separate legal entities or entities recognized by law, regardless of whether those entities have a legal personality.

A joint arrangement that is structured through a separate vehicle can be either a joint venture or a joint operation depending on the parties' rights to the assets, and obligations for the liabilities, relating to the arrangement.

## **The legal form of the separate vehicle**

The assessment of the rights and obligations conferred upon the parties by the legal form of the separate vehicle is sufficient to conclude that the arrangement is a joint operation only if the parties conduct the joint arrangement in a separate vehicle whose legal form does not confer separation between the parties and the separate vehicle (that is, the assets and liabilities held in the separate vehicle are the parties' assets and liabilities).

However, the terms agreed by the parties in their contractual arrangement and, when

relevant, other facts and circumstances can override the assessment of the rights and obligations conferred upon the parties by the legal form of the separate vehicle.

## **The terms of the contractual arrangement**

The rights and obligations agreed to by the parties in their contractual arrangements are normally consistent, or do not conflict, with the rights and obligations conferred on the parties by the legal form of the separate vehicle in which the arrangement has been structured. In other cases, the parties use the contractual arrangement to reverse or modify the rights and obligations conferred by the legal form of the separate vehicle in which the arrangement has been structured.

The parties to joint arrangements are often required to provide guarantees to third parties that, for example, receive a service from or provide financing to the joint arrangement. The provision of such guarantees, or the commitment by the parties to provide them, does not, by itself, determine that the joint arrangement is a joint operation.

## **Other facts and circumstances**

When the terms of the contractual arrangement do not specify that the parties have rights to the assets, and obligations for the liabilities, relating to the arrangement, the parties shall consider other facts and circumstances to assess whether the arrangement is a joint operation or a joint venture.

A joint arrangement might be structured in a separate vehicle whose legal form confers separation between the parties and the separate vehicle. The contractual terms agreed among the parties might not specify the parties' rights to the assets and obligations for the liabilities, yet consideration of other facts and circumstances can lead to such an

arrangement being classified as a joint operation. This will be the case when other facts and circumstances give the parties rights to the assets, and obligations for the liabilities, relating to the arrangement.

In this connection, the entity is required to analyse whether the other facts and circumstances do the following:

- (a) Give the parties rights to substantially all of the economic benefits relating to the arrangement; and
- (b) Result in the parties being substantially the only source of cash flows contributing to the arrangement, indicating that they have an obligation for the liabilities related to the arrangement.

When the activities of an arrangement are primarily designed for the provision of output to the parties, this indicates that the parties have rights to substantially all the economic benefits of the assets of the arrangement. The parties to such arrangements often ensure their access to the outputs provided by the arrangement by preventing the arrangement from selling output to third parties.

The effect of an arrangement with such a design and purpose is that the liabilities incurred by the arrangement are, in substance, satisfied by the cash flows received from the parties through their purchases of the output. When the parties are substantially the only source of cash flows contributing to the continuity of the operations of the arrangement, this indicates that the parties have an obligation for the liabilities relating to the arrangement.

## **Example**

The standard provides an example in which there are two parties, which structure a joint arrangement in an incorporated entity so that

each party has a 50 percent ownership interest.

The purpose of the arrangement is to manufacture materials required by the parties for their own individual manufacturing processes. As the arrangement is structured through a separate vehicle, there is an initial indication that the arrangement is a joint venture.

The contractual arrangement between the parties does not specify that the parties have rights to the assets or obligations for the liabilities of the arrangement. Accordingly, the terms of the contractual arrangement indicate that the arrangement is a joint venture.

However, the parties also consider the following aspects of the arrangement:

- The parties agreed to purchase all the output produced by the arrangement in a ratio of 50:50 and that it cannot sell any of the output to third parties unless this is approved by the two parties.
- The price of the output sold to the parties is set by both parties at a level that is designed to cover the costs of production and

administrative expenses incurred by the arrangement. On the basis of this operating model, the arrangement is intended to operate at a break-even level.

The following facts and circumstances are relevant:

- The obligation of the parties to purchase all the output produced by the arrangement reflects the exclusive dependence upon the parties for the generation of cash flows and, therefore, the parties have an obligation to fund the settlement of the liabilities of that arrangement.
- The fact that the parties have rights to all the output produced by the arrangement means that the parties are consuming, and therefore have rights to, all the economic benefits of the assets of the arrangement.

These facts and circumstances indicate that the arrangement is a joint operation. The conclusion about the classification of the joint

arrangement in these circumstances would not change if, instead of the parties using their share of the output themselves in a subsequent manufacturing process, the parties sold their share of the output to third parties.

On the other hand, if the parties changed the terms of the contractual arrangement so that the arrangement was able to sell output to third parties, this would result in that arrangement assuming demand, inventory and credit risks. In that scenario, such a change in the facts and circumstances would require reassessment of the classification of the joint arrangement. Such facts and circumstances would indicate that the arrangement is a joint venture.



Send your questions and comments to [commentletters@hkiicpa.org.hk](mailto:commentletters@hkiicpa.org.hk). The standard setting team will answer these questions in accordance with its policy, posted on the Institute's website.

